EUROPEAN INTERNATIONAL UNIVERSITY

MGT570: Financial Management

Unit 20: Short-Term Financing

This unit discusses the sources of short-term financing an enterprise can use to fund its projects, credit financing, accounts receivable financing and inventory financing.

ILO1: Credit Financing
ILO2: Accounts Receivable Financing
ILO3: Inventory Financing

ILO1: Credit Financing

If a firm needs a short-term source of cash to fund its growth there are, as we know, several sources available.

Trade Credit is usually the largest source of short-term financing. It is a spontaneous source of funds that changes as sales expand or contract. Credit period is set by terms of credit but firms may be able to "stretch" the payment period.

Trade credit is affected by the following policies:

1. Cash discount policy: Means that suppliers may provide a cash discount for early payment.

Foregoing discounts can be very expensive. The cost of failing to take a discount is computed as follows:

$$\text{Cost of failing to take a cash discount} = \frac{\text{Discount percent}}{\text{100 percent - Discount percent}} \times \frac{360}{\text{Final due date - Discount period}}$$

Whether a firm should take a discount depends on the relative costs of alternative sources of financing.

2. Net Credit Position: It is the relationship between a firm's level of accounts receivable and its accounts payable determines its net trade credit position. If the firm's average accounts receivable exceeds average accounts payable, it is a net provider of credit. If payables exceed receivables, the firm is a net user of trade credit.

Bank Credit is another popular form of credit financing. Banks usually prefer short-term, self-liquidating loans, or open credit lines. Bank loan terms and concepts include the following:

a. *Prime rate*, is the interest rate charged to the most creditworthy borrowers. The prime rate serves as a base in determining the interest rate for various risk classes of borrowers. For

instance, the prime rate of New York banks receives much attention from government officials in managing the economy; and the London Interbank Offer Rate (LIBOR) on U.S. dollar deposits is being used worldwide as a base lending rate on dollar loans.

b. ***Compensating balances***, are a loan condition, when a borrower may be required to maintain a minimum average account balance in the bank equal to a percentage of loans outstanding or a percentage of future bank commitments, and/or pay a fee for services. Compensating balances raise the cost of a loan and compensate the bank for its services. If a compensating balance is required, the borrower must borrow more than the amount needed.

c. ***Maturity provisions,*** general requirements as to when the debt has to be repaid. Most bank loans are short term and mature within a year. In the last decade more banks have extended intermediate-term loans (one to seven years) that are paid in installments.

d. ***Costs of commercial bank financing,*** the effective interest rate on a loan depends on the loan amount, interest paid, length of the loan, and method of repayment.

Bank credit availability tends to cycle. For instance, credit crunches seem to appear every 3–5 years. The pattern of the credit crunch has been as follows:

- Central Banks tightens the money supply to fight inflation.
- Lendable funds shrink, interest rates rise.
- Business loan demand increases due to price-inflated inventories and receivables.
- Depositors withdraw savings from banks to seek higher return elsewhere, further reducing bank credit availability.

Another thing to be considered in bank credit is collateral. The lending institution may require collateral to be pledged when granting a loan. Lenders lend on the basis of the cash flow capacity of the borrower. Collateral is an additional but secondary consideration.

ILO2: Accounts Receivable Financing

There are three main ways to use accounts receivables to obtain short term financing, all include a certain extent of factoring.

Pledging accounts receivable as collateral is also a possible way of short-term financing.

Receivable levels are rising as the need for financing is increasing. However, it may be relatively expensive and preclude use of alternative financing sources. It may be also viewed as a form of factoring. Lender screens accounts and loans a percentage (60 to 80 percent) of the acceptable amount. Lender has full recourse against borrower. The interest rate, which is usually well in excess of the prime rate, is based on the frequently changing loan balance outstanding.

Factoring Receivables is a direct sale of receivables, when receivables are sold, usually without recourse, to a factoring firm. A factor provides a credit-screening function by accepting or rejecting accounts. Factoring costs include the commission of 1 to 3 percent of factored invoices and an interest on advances.

Another way is an asset-backed public offering of receivables, essentially it is a public offering of securities backed by receivables as collateral are a means of short-term financing. In relation to this method several problems exist:

(1) Historically, firms that sold receivables were considered to be in financial trouble.
(2) The receivables might not be paid in the case of a recession or credit crisis.

Of all receivables-based methods to obtain short term financing pledging receivables as collateral and direct factoring remain the most widely used.

ILO3: Inventory Financing

When a short-term financing is needed a firm may use the inventory as collateral as well. The collateral value of inventory is based on several factors.

The first factor is marketability of the inventory. It is known that raw materials and finished goods are more marketable than goods-in-process inventories, thus they can be easily accepted as collateral. Standardized products or widely traded commodities also qualify for higher percentage loans.

Another factor is price stability, describing whether the inventory maintains a stable market price, goes down in value or appreciates.

Perishability is another point to consider, some inventory is subjected to spoilage, thus it is perishable. Perishables are not eagerly accepted as collateral.

The fourth factor is physical control, or the requirement of the lender to obtain the inventory physically. Three ways are possible:

- Blanket inventory liens: lender has general claim against inventory of borrower. No physical control.
- Trust receipts: also known as floor planning; the borrower holds specifically identified inventory and proceeds from sales in trust for the lender.
- Warehousing: goods are physically identified, segregated, and stored under the direction of an independent warehousing company. Inventory is released from warehouse openly upon presentation of warehouse receipt controlled by the lender. It can be a public or a field warehouse. Public warehouse is a facility on the premises of the warehousing firm. Field warehouse is an independently controlled facility on the premises of borrower.

Inventory financing and the associated control methods are standard procedures in many industries.

References:

1. Managerial Accounting. 16th Edition, by Ray Garrison and Eric Noreen and Peter Brewer, McGraw-Hill, 2018.
2. Block, Hirt, Danielson (2011). Foundations of Financial Management (17th ed.). McGraw-Hill, 2019.

EIU - PARIS
paris, France